THE FEDERAL RESERVE BANK of ST. LOUIS

SUPERVISORY ISSUES

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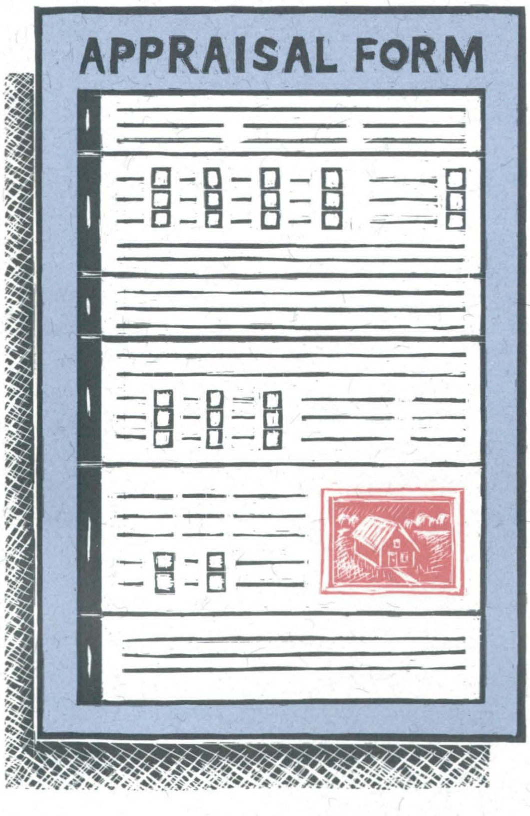
Supervisory News and Views for the Eighth District

Fed Revises Guidelines for Real Estate Appraisal Programs

Revised guidelines implementing changes to real estate appraisal regulations now allow choices for appraisal scope and report formats, and relax requirements for reappraisals on existing credit relationships. Many transactions which are newly exempt from complete appraisals, however, require written "evaluations."



Transactions Requiring Complete Appraisals

Most real estate transactions over $250,000 are federally related transactions and require a "complete" appraisal, which contains the five minimum appraisal standards. The appraisal must:

- conform to USPAP standards, unless safety and soundness concerns require compliance with stricter standards;
- be in writing and contain sufficient information and analysis to support the institution's decision to engage in the transactions;
- analyze and report appropriate deductions and discounts for proposed construction or renovation;
- be based on the definition of market value; and
- be performed by state-licensed or certified appraisers.

When "Limited" Appraisals are Appropriate

The guidelines now permit banks to accept "limited" appraisals conducted in accordance with the USPAP Departure Provision. The bank and the appraiser must agree that the Departure Provision is appropriate before the appraisal is commenced. For example, a limited appraisal may be appropriate when a property unique to the market, such as a recycling facility, has no comparable sales information and the appraiser therefore would not utilize the market data approach to value. Banks should be cautious when agreeing to limited appraisals because these are less thorough reviews.

"Summary" or "Restricted" Reports

Banks are no longer required to obtain the traditional "self-contained" appraisal report,

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Revised Guidelines

(continued from front page)

but may now accept shorter reports with either "summary" or "restricted" formats. Summary reports are condensed versions of the self-contained report, while restricted reports present only conclusions and no analysis. Bank policies should identify the type of report format that is acceptable for the transaction based on an assessment of risk factors. A significant number of restricted reports are not appropriate because the supporting information and analysis are limited.

Evaluations

An evaluation is a less formal written opinion of value which may be performed by a qualified individual who is not an appraiser. Under the new regulations, an evaluation is normally required for:

1) loans secured by real estate below a $250,000 threshold;
2) business loans below $1 million where income from real estate collateral is not the primary source of repayment; and,
3) renewal or refinancing of an existing loan when:
   (a) only closing costs are advanced; or,
   (b) new funds are advanced as long as the institution's collateral protection is not threatened.

Evaluations should also be obtained for other transactions which the bank considers necessary to ensure sound underwriting. For example, an evaluation would be appropriate to support the typical home equity loan, especially when higher loan-to-value ratios are being permitted or a concentration exists. Policies should set standards for contents of evaluations which, at a minimum, should contain calculations, supporting assumptions, and a discussion of any comparable sales data.

Useful Life of Appraisals and Evaluations

Bank policies should contain clear guidelines for determining when an appraisal or evaluation is no longer valid. There is no longer a presumption that a new appraisal is required when advancing new funds or altering the terms of an existing loan, or when the loan's credit quality has deteriorated. The revised guidelines permit banks to use an existing appraisal or evaluation to support a subsequent transaction, if the bank documents that the existing estimate of value remains valid. To support such a conclusion, the bank must assess factors relating to the physical aspects of the property or the market to determine whether there could be a material change in values.

For example, an additional advance on an existing loan to remodel or upgrade a property is permitted without obtaining a new appraisal, as long as the quality of the property is sound and the bank's resulting loan-to-value remains satisfactory. In this case, an evaluation is all that is required. The bank's programs should clearly establish when a new appraisal is required, and that internal procedures provide for documentation of information sources and analyses utilized to determine the continuing validity of appraisals.

Selecting the Appraiser or Evaluator

The appraiser must be directly engaged by the bank and be a competent individual subject to effective professional supervision. Persons performing evaluations need not be appraisers, but should have appropriate training, and experience and knowledge of the relevant market. Banks should establish criteria for selecting, evaluating and monitoring individuals performing appraisals and evaluations.

Bank policies should identify acceptable appraisal report formats based on an assessment of risk factors.

Banks should also develop an internal list of approved appraisers and evaluators and a process for removing substandard performers.

Appraisals and Evaluations in the Credit Process

Because the appraisal and evaluation program is an important component of credit underwriting, it must be separate from the loan approval function to avoid compromising the valuation process. In a small or rural institution, the bank's own loan officers may be the most qualified to conduct appraisals or evaluations. This arrangement is permissible as long as prudent safeguards are established, such as recusing that loan officer from the final credit decision.

Appraisals and evaluations must be received and assessed *before* the bank enters into a binding commitment. Because appraisers and evaluators often carry heavy workloads and are under pressure to meet tight deadlines, the possibility of errors and inconsistencies can be material. Banks must have adequate procedures to ensure that each appraisal or evaluation receives appropriate review and any errors are corrected *before* the credit decision is made.

Internal Controls

Effective internal controls should be established to ensure that the bank maintains a satisfactory program. The bank should designate a competent individual to conduct compliance reviews which include sampling of individual appraisals and evaluations. The compliance review must be documented, either in narrative form or by checklist, and should ensure that corrective action is taken to eliminate noted deficiencies.

A bank's board of directors is responsible for reviewing and adopting policies and procedures that establish an effective real estate appraisal and evaluation program.

By Barkley Bailey, a Field Director at the Federal Reserve Bank of St. Louis.

Regulation H Permits Public Welfare Investments

The Fed recently amended Regulation H to permit a state member bank to invest up to 5 percent of its equity capital plus loan loss reserves in certain public welfare investments that are permitted by state law. An investment in any one project is limited to 2 percent of equity plus reserve.

If the investment fits clearly into one of the following categories, it may be made without prior approval:

- an investment previously determined to be a public welfare investment by the Board or by the Comptroller of the Currency;
- an investment in a community development financial institution, as defined in the Community Development Banking and Financial Institutions Act of 1994;
- an investment in low- and moderate-income housing;
- an investment in non-residential real estate development in a low- or moderate-income area that is targeted towards low- and moderate-income persons;
- an investment relating to small business development in a low- or moderate-income area;
- an investment relating to job training or placement for low- and moderate-income persons;
- an investment relating to job creation in a low- or moderate-income area for low- and moderate-income persons; or
- an investment relating to technical assistance and credit counseling to benefit community development.

In addition, the bank must be:

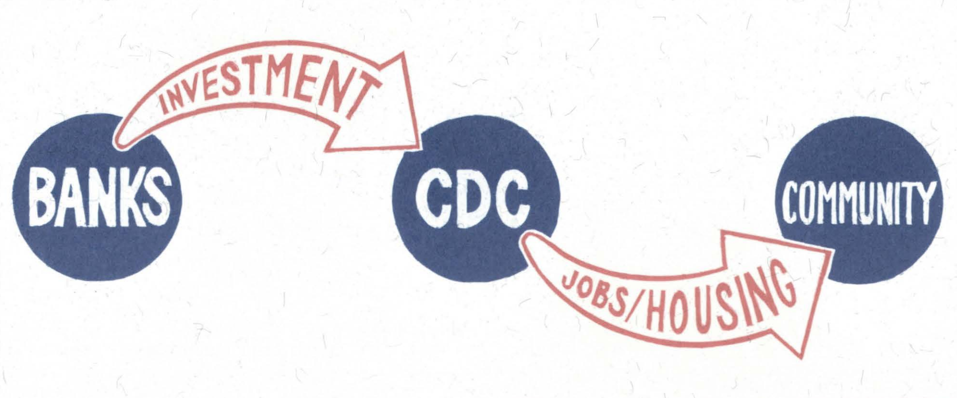
- "adequately capitalized";
- rated CAMEL composite 1 or 2; and
- rated "satisfactory" for consumer compliance and have no outstanding supervisory actions.

If both the financial and investment criteria are met, the public welfare investment may be made without prior Fed approval. Within 30 days of making the investment, the bank must advise the Reserve Bank, in writing, of the amount of the investment and the identity of the entity in which the investment was made. Proposals that do not meet the above requirements must proceed by way of applications.

If financial and investment criteria are met, the public welfare investment may be made without prior Fed approval.

The Fed also revised an interpretation of Regulation Y, relating to public welfare investments by bank holding companies, to permit companies that have received approval to engage in activities that promote community welfare to make additional investments of the type that are permissible for state member banks without additional Fed approval. These additional investments can be made if the holding company's total public welfare investments, when aggregated with the public welfare investments made by its bank and thrift subsidiaries, do not exceed 5 percent of the holding company's consolidated equity capital and loan loss reserve.

If you have questions, please call Supervisory Officer Dennis Blase at (314) 444-8435.



Risk-Based Capital Guidelines Incorporate New Accounting Rules

The Fed, along with the other federal banking agencies, has amended the risk-based capital guidelines for state member banks and bank holding companies to address the capital treatment of new accounts created by FAS 115, "Accounting for Certain Investments in Debt and Equity Securities," and FAS 109, "Accounting for Income Taxes."

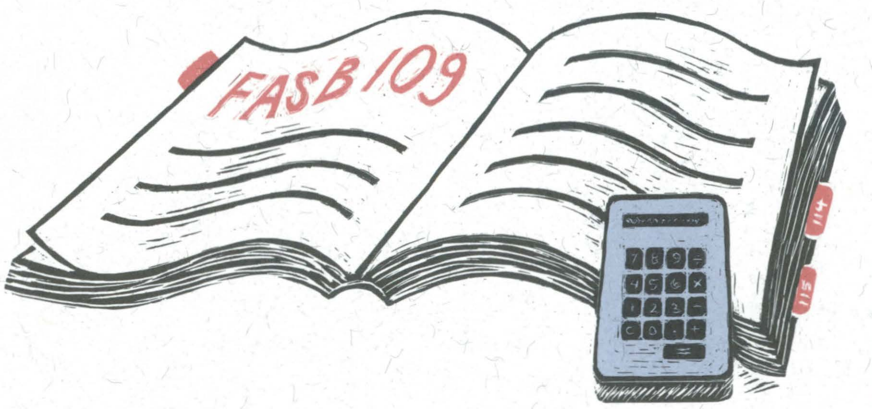
FAS 115 - Accounting for Certain Investments in Debt and Equity Securities. The capital guidelines are amended to exclude from Tier 1 and Tier 2 capital net unrealized gains and losses from available-for-sale *debt* securities and net unrealized *gains* from marketable *equity* securities. Net unrealized *losses* on marketable *equity* securities, however, should be deducted from Tier 1 capital.

FAS 109 - Accounting for Income Taxes. The amended capital guidelines limit the amount of deferred tax assets an institution may include in Tier 1 capital to the lesser of:

1) the amount of deferred tax assets the institution expects to realize within one year of the quarter-end report date, based on its projection of taxable income; or
2) 10 percent of Tier 1 capital.

In addition, the portion of the allowance for loan and lease losses established in accordance with FAS 114, "Accounting by Creditors for Impairment of a Loan," should be reported on the call report as part of the general valuation allowance, rather than as a separate, specific allowance. Thus, this portion of the allowance will continue to be included in Tier 2 capital, subject to existing limits. Regulatory nonaccrual rules will be retained and no new reporting items will be required as a result of the implementation of FAS 114.

By Paul Lippold, an Examiner at the Federal Reserve Bank of St. Louis.



Reporting Requirements Change for Bank Holding Companies

Changes to the Annual Report of Bank Holding Companies (Form FR Y-6), effective for the December 31, 1994, reporting period, revise audit requirements and eliminate several report items.

Bank holding companies will no longer submit audited financial statements as part of the FR Y-6. However, top-tier bank holding companies with total consolidated assets of $500 million or more must have an annual audit of their consolidated financial statements by an independent public accountant.

In addition, amendments to the articles of incorporation and confirmation of changes in investments and activities will no longer be reported on the FR Y-6. Nonbank subsidiary financial statements and insider loan disclosures will be submitted with other required reports.

An organization chart, report to shareholders, list of officers and directors, list of principal shareholders and Form 10-K will continue to be required as part of the report. The report is due no later than 90 days after the end of the company's fiscal year. To assist those holding companies who must file by March 31, filing instructions will be mailed shortly. For questions concerning the FR Y-6, call Cynthia A. Koch at (314) 444-4630 or Jim Mack at (314) 444-8599.

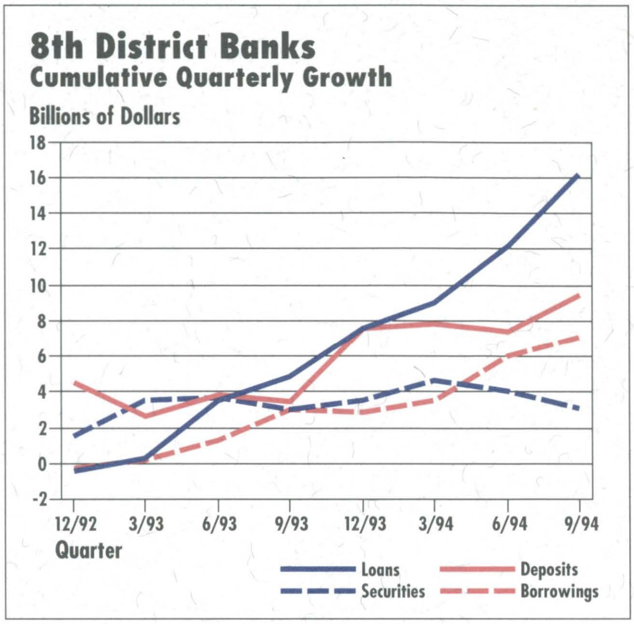
By Cynthia A. Koch, an Assistant Examiner at the Federal Reserve Bank of St. Louis.

Bank Performance

Deposit Increases Fund Loan Growth

Loans at Eighth District institutions continued to grow vigorously in the quarter ended September 30, 1994. Total loans grew by roughly $4.25 billion, an 18 percent increase, at an annualized rate, since June. All loan categories contributed to the increase, with real estate-secured loans accounting for 60 percent and consumer loans accounting for 23 percent of the jump in total loans. Robust total loan growth pushed loans as a percentage of total assets to a four-year high of 59.2 percent. The ratio had fallen as low as 54.1 percent in the fourth quarter of 1992.

District banks used the liability side of their balance sheets to fund most of the loan growth. Indeed, in the third-quarter total deposits, particularly non-transaction accounts, grew at a 6.2 percent annualized rate. In comparison, total deposits grew by an anemic 2.3 percent from the end of 1992 through June 30, 1994. The $2.01 billion rise in total deposits covered almost one-half of the increase in total loans.

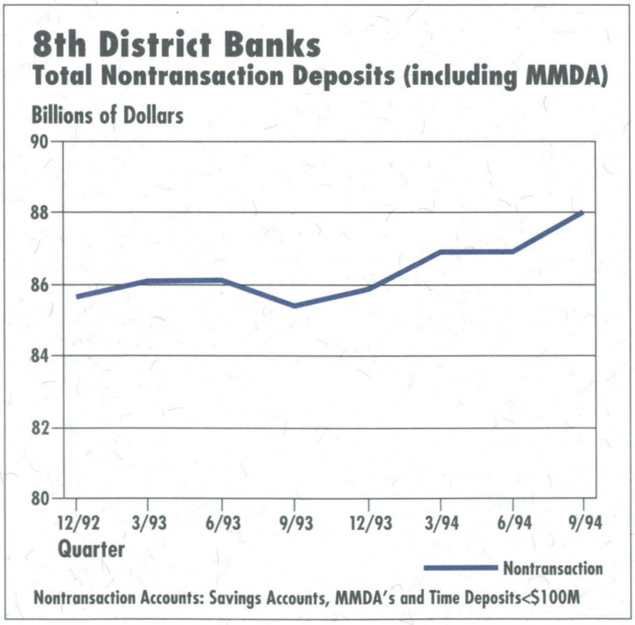


Increases in short-term borrowings covered another one-third of District loan growth. Slightly over one-half of the $1.41 billion rise in short-term borrowings came from overnight repurchase agreements. Additionally, district banks continued to be a net purchaser of federal funds, buying roughly 3.5 billion more fed funds than they sold in the third quarter.

Loan growth also resulted in adjustments on the asset side of the balance sheet. Between June 30 and September 30, District banks trimmed their total securities holdings by $1.15 billion, a figure that represents over one-quarter of total loan growth. The greatest decrease came from available-for-sale U.S. Treasury securities ($1.2 billion). In contrast, held-to-maturity securities showed a $0.6 billion increase.

In summary, though loans grew briskly in the third quarter, the growth was matched in part by an increase in deposits, and balances reflect more interest rate risk. The shift toward short-term liabilities has not yet adversely affected net interest margins as evidenced by stable funding costs.

By Andrew P. Meyer, an Associate Economist at the Federal Reserve Bank of St. Louis.



Changes in Call Reports Address Derivatives

The FFIEC has announced changes to the Call Report effective March 31, 1995. These changes will increase information on the extent and associated risks of banks' involvement in derivative activities, including mortgage-backed securities, off-balance-sheet contracts and structured notes. The new disclosures will permit strengthened analyses of these activities and the resulting exposure on banks' capital.

Other revisions clarify reporting for mutual funds sales and adjustments for reciprocal demand balances and incorporate changes in accounting standards.

Highlights of the changes are:

Derivatives Activities

- Schedule RC-B will be revised to collect data on *all* mortgage-backed securities, so that overall holdings of these instruments will be disclosed concisely. Also, memorandum items will be added for "high-risk mortgage securities" and "structured notes," which are potentially more volatile instruments. In addition, related instructions are being clarified.
- Schedule RC-L will contain an expanded matrix showing all off-balance-sheet derivative contracts, both exchange-traded and over-the-counter, categorized by the four types of underlying risk exposure - interest rate, foreign exchange, equity, and commodity/other. Banks over $100 million in assets will also report the fair value of these derivatives contracts.
- Schedule RC-R will collect both net current credit exposure and notional principal value of off-balance-sheet derivative contracts, reflecting forthcoming changes in risk-based capital rules.
- Schedule RI will contain new items for disclosing trading revenue from derivatives and the related impact on net income for banks over $100 million in assets.

Other Revisions

- Schedule RC-M will collect the sales volume of *proprietary* mutual funds and annuities.
- Schedule RC-O will show adjustments to demand deposits for certain reciprocal demand balances which are needed for accurate calculation of deposit insurance assessments.
- Banks will be required to implement FASB 114, "Accounting by Creditors for Impairment of a Loan," which principally affects calculation of the valuation reserve and bad debt expense.
- There will be several deletions, primarily involving detail items for restructured loans and risk-based capital. Also, there are instructional changes for extensions of credit to insiders, refundable loan commitment fees and stock subscription payments.

By Frank Bufe, an Assistant Manager in Regulatory Reporting at the Federal Reserve Bank of St. Louis.

THE FEDERAL RESERVE BANK of ST. LOUIS

Post Office Box 442
St. Louis, Missouri 63166

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